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No. 17,313

United States Court of Appeals

For the Ninth Circuit

FRANCIS L. ROONEY and IRENE ROONEY, his wife,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

BRIEF FOR APPELLANTS FRANCIS L. ROONEY AND IRENE ROONEY

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IN THE

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Francis L. Rooney and Irene Rooney, his wife, *Appellants,* vs. United States of America, *Appellee.*	

BRIEF FOR APPELLANTS FRANCIS L. ROONEY AND IRENE ROONEY

This is an appeal to the United States Court of Appeals for the Ninth Circuit from a final judgment of the United States District Court for the Northern District of California, Northern Division, rendered November 14, 1960.

STATEMENT OF JURISDICTION

These proceedings were commenced by appellants pursuant to the provisions of Section 6532 of the Internal Revenue Code of 1954. 28 U. S. Code, 1346(a).

STATEMENT OF THE CASE

This controversy involves a proper determination of appellants' liability for federal income taxes for the years 1952-1953 and 1954. Appellants sustained a net operating loss in the year 1954 which was carried back and deducted from income for the years 1952 and 1953 in accordance with the provisions of Section 172 of the Internal Revenue Code of 1954 (formerly Section 122, Internal Revenue Code, 1939). The Commissioner thereafter determined that there were deficiencies in income tax for those years, and for 1954, and after paying them appellants filed claims for refund for each of the years involved, copies of said claims being incorporated in the record on appeal in this case, which were each ultimately denied by the Commissioner in his Notice of Disallowance.

The facts of this case, other than the ultimate findings of the District Court, are not substantially in dispute. Appellants are individuals who at all times involved in this proceeding were residents of the County of Sacramento, California. They filed their income tax returns on a calendar year basis at San Francisco, California.

SPECIFICATIONS OF ERROR RELIED UPON

The appellants specify each of the following as error on the part of the District Court:

(1) That the allocation of expenses to appellants' successor corporation achieved the equating of income and expenses which would have resulted if appellants

had dealt with their controlled corporation as they would have with a stranger corporation.

(2) That the allocation resulted in a "matching" of income and expense, and, therefore, more clearly reflected income.

(3) That the entities involved had the element of "common control" required by Section 45.

(4) That the principles of the pertinent authorities do not establish that the action of the Commissioner under all the facts and circumstances was arbitrary and erroneous.

(5) That appellants were not entitled to deduct the expenses incurred by them individually and to carry back their net operating loss as expressly authorized by the provisions of Section 122 of the Internal Revenue Code of 1939.

(6) That appellants were not entitled and required to report the transaction in question in accordance with the provisions of Section 112(b)5 of the Internal Revenue Code of 1939 relating to tax free incorporations.

(7) That appellants failed to sustain their burden of proof as to the amount of the tax refund owing.

STATEMENT OF FACTS

Appellants were hop ranchers who, in the early spring of 1954, consulted their accountant regarding the formation of a partnership or a corporation with

an eye toward developing a program for transferring an interest in the family business to two adult sons and lessening the immediate impact of taxes upon the income of their business.

At the suggestion of the accountant, appellants consulted an attorney who advised that their objectives could best be achieved by incorporating the business. They organized a corporation on May 27, 1954, for that purpose. Pursuant to a permit from the California Corporations Commissioner, the corporation issued its capital stock in exchange for the assets of the hop growing business of appellants, subject to liabilities, as of July 31, 1954. On that date, the assets of the business included a partially matured crop. Because of Section 112(b)(5) of the Internal Revenue Code of 1939 (I.R.C. 1954, Sec. 351), no gain was recognized on the transfer. During the period January 1, 1954, to July 31, 1954, the proprietorship had incurred substantial expense in planting and cultivating the crop. Since the crop had not yet matured, the proprietorship realized no income from it. As a result, the method of accounting regularly used by the proprietorship reflected a net loss for the period. During the period appellants incurred the expenses of planting and cultivating the crop, the corporation owned no assets and engaged in no business activity whatsoever.

NATURE OF THE CONTROVERSY

The loss sustained in the final accounting period of the proprietorship was, in accordance with Section 122 of the Internal Revenue Code of 1939, carried back to prior years and resulted in over-payments of taxes for those years with respect to which a claim for refund was duly filed.

This claim was allowed by the Commissioner of Internal Revenue who later reversed his position and asserted deficiencies in tax for the years covered by the refund claim upon the ground that the expenses admittedly incurred by the proprietorship long prior to the time the corporation commenced business activity were nevertheless allocable to it. The allocation of these expenses to the successor corporation was made under the purported authority of Section 45 of the Internal Revenue Code of 1939, the pertinent provisions of which read as follows:

> "* * * the Commissioner is authorized to distribute, apportion or allocate gross income, deductions, credits, or allowances between or among [businesses owned or controlled directly or indirectly by the same interests] * * * if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses."

The allocation resulted in the crop expenses of 1954 and 1955 being included in the corporation return for the fiscal period August 1, 1954, to July 31, 1955, while the same return included only the income from the crop sold in the fall of 1954.

SUMMARY OF ARGUMENT

I.

A. The action of the Commissioner in invoking Section 45 fails to meet the avowed purpose of that section, namely to more clearly reflect income, as it does not achieve a matching of income and expense. Rather, it results in the expenses of raising two crops being offset against the sale proceeds of one crop.

B. Nor is this action justified by any concept that the use of Section 45 puts appellants in the same position as they would have been in an arm's length transaction. In fact, appellants would have received more favorable tax treatment in an arm's length transaction, irrespective of Section 45, and the application of that section places them in the worst possible tax position.

C. Controlling authority demonstrates that expenses cannot be allocated in a tax-free incorporation and that the attempted invocation of Section 45 here, being both novel and aberrational from the principles of the decided cases, is arbitrary and erroneous.

II.

Sustaining this allocation has the same effect as requiring appellants to inventory an unharvested crop, a result specifically forbidden by the Commissioner's own regulations and the decided cases.

III.

Because appellants and their corporation represented successive rather than parallel entities, the

"common control" required before Section 45 can have any application was not present in this case.

IV.

Appellants have established, through the admissions of appellee, the exact amount of the refund to which they are entitled as a result of the Commissioner's unjustified allocation of expenses and the consequent denial of the refund owing to appellants.

THE ISSUE OF THE CASE

The Commissioner does not dispute that the expenses incurred by appellants in growing the crop up until the time it was transferred to the corporation in exchange for its stock were, in accordance with its regular method of accounting, deductible by them. Nor does the Commissioner dispute that the gain to appellants arising from the transfer of, inter alia, the unmatured crop to the corporation was properly deferred in accordance with the clear and unambiguous language of Section 112(b)(5) of the 1939 Code. The sole question at issue here is whether in the circumstances of this case the Commissioner was authorized by Section 45 not only to artificially shift income and expense to place the appellants in the worst possible tax position but also to prevent the normal operation of Section 112(b)(5).

ARGUMENT

I

The Internal Revenue Service is making an entirely new contention in the present case—a contention completely at odds with the principles of the decided cases and representing a radical departure from accepted farm accounting principles. There are no prior cases holding that a tax free incorporation can be the basis for disallowing expenses incurred in connection with the property transferred.

It must be made clear at the outset that appellants' transaction never presented any threat of permanently immunizing gain or income from reach of the taxing power. The Commissioner did not need to invoke Section 45 to avoid any such threat. There would never be ultimate immunity from tax here; the most that would obtain would be deferment of tax liability. Moreover, as will be shortly demonstrated, the ultimate tax impact on appellants (even without any "allocation" by the Commissioner) would have been *more severe* in the context of this tax-free transfer than in a similar but arm's length transaction.

To understand the foregoing principles, we need but assume there were no allocation by the Commissioner. The eventual tax position of appellants and the corporation would then develop as follows: (1) appellants would have incurred expenses without offsetting income in 1954, giving rise to their net operating loss; (2) the corporation's revenues from the sale of its first crop in the fall of 1954, less the expenses of

harvesting, would be offset by the subsequent expenses of planting and cultivation incurred in the spring of 1955. (The corporation's taxable year ran and still runs from August 1 to July 31.) This cycle would have been repeated each taxable year, with net revenues from the harvest and sale each fall being offset by planting and cultivating expenses of the spring following. In the corporation's final taxable year, receipts from sale of its fall crop would be offset only by harvesting expenses, since the corporation would plant no new crop the following spring. Those receipts would incur tax at ordinary income rates. In other words, the corporation would have never obviated payment of ordinary income tax on receipts from that final crop against which no ensuing planting expenses could be balanced. And, indeed, appellants never intended that the corporation obviate such ultimate liability.

The Commissioner would use his discretion to prevent the postponement of tax just described. He would—despite utter lack of authority holding that a tax-free incorporation can be the basis for disallowing expenses incurred in connection with the property transferred—preclude the normal operation of Section 112(b)(5). He would do all of this, and also put the taxpayer in the worst possible position, while failing to approximate the basic concept of Section 45.

For Section 45 speaks of clearly reflecting income. The Commissioner's and the District Court's concept is that the cost of producing a crop should be matched against the proceeds of its sale. But the Commis-

sioner's action would give the corporation in the taxable year 1954-55, deductions for the expenses of raising *two* crops—that planted in the spring of 1954 and that planted in the spring of 1955—and the income from the sale of only *one.* Since the invocation of Section 45 here achieves only a distortion of expenses vis-a-vis income, there is no justification for its use.

Moreover, there are many situations in which the government requires a separation of the proceeds of the sale of a crop and the expenses of producing it. For example:

1. Where crops are held over and not sold until the succeeding fiscal year—or even, in the case of a cash basis taxpayer, when they are sold but payment is deferred. See

   Amend, 13 T.C. 178, acq. 1950-1 Cum. Bul. 1,

   cited with approval in

   Rev. Rul. 60-31, 1960-1 Cum. Bul. 174, 178;

2. Where a new entity first goes into the farming business; and

3. Where a farmer dies prior to sale of the crops. Compare

   Rev. Rul. 58-436, 1958-2 Cum. Bul. 366,

   and

   Estate of Tom L. Burnett, 2 T. C. 897, acq. 1944 Cum. Bul. 4.

In upholding the Commissioner, the District Court relied on the proposition that Section 45 could be invoked to reach a tax result consonant with that which

would have obtained in an arm's length transaction. But the absence of any such consonance in this case is obvious. Appellants would have had no tax advantage over an arm's length transferor irrespective of the effect of Section 45. If Section 45 is superimposed on this situation, then appellants suffer the worst possible result.

To understand the comparison, we need only visualize what an arm's length situation would have entailed. In a transfer to a non-owned corporation, appellants would have placed a value on the unharvested crops. (As a matter of fact they would have been so required by law. *Watson v. Commissioner* (1953) 345 U.S. 544, 97 L. Ed. 1232.) This value would have determined the number of shares of stock acquired in the exchange. The receipt of these shares and the value assigned to them would have created a taxable capital gain (I.R.C., 1954, Sec. 1231(b)(4)). The net taxable gain would have been the difference between the value received and the cost of producing the crop, which would have to be capitalized, rather than expensed, in the year of sale (I.R.C. 1954, Sec. 261). Transfer to a non-owned corporation thus would have achieved conversion of an ordinary income item (the crop) into a *capital asset.*

In contrast, because the transfer in issue was to a wholly owned corporation,[1] the crop retained its character as stock in trade, and the corporation paid ordinary income tax when the crop was sold. We have already seen (p. 9) how the corporation would, in any event, have to pay *ordinary income tax* on its

final harvest revenues. Weighing the capital gain tax against the ordinary corporate income tax, we find the impact of dealing with their wholly-owned transferee puts appellants in a *less favorable* tax position than would have resulted from the "arm's length" situation. True, there would be postponement of the ordinary income tax liability under appellants' arrangement. But when cut, the tax slice would be substantially bigger.

But the Commissioner is not satiate with this bigger slice. His ingenious invocation of Section 45 places appellants in the worst possible tax position. This is so because appellants are denied the right to avail themselves of the provisions of Section 122 which permit the offset of the expenses incurred by them as individuals against income earned by them as individuals.

It was upon a misapprehension of the nature of the tax result to be accorded an "arm's length transaction" that the District Court sought to distinguish the case of *Simon J. Murphy Co. v. Commissioner of Internal Rev.* (6th Cir. 1956) 231 F. 2d 639. There a corporation distributed its assets, consisting of real properties, in liquidation to its shareholders on January 11, 1950. On January 1, 1950, substantial real estate taxes had become a lien on the properties distributed. The transferor, an accrual basis taxpayer,

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[1]The control of the successor corporation by appellants at the date of transfer brings into play I.R.C. 1939, Section 112(b)(5), presently I.R.C. 1954, Section 351, which provides for the nonrecognition of gain or loss.

deducted the full amount of the taxes thereby sustaining a net operating loss for 1950, since little income was realized during the eleven day period. For reasons hereinafter discussed (p. 17), the Court of Appeals held that the Commissioner had abused his discretion in allocating the expenses of the transferor to the transferee.

While it is true as the District Court points out, that under existing law there were no provisions for the ratable allocation of real property taxes as between a vendor and a vendee, it is not true that the same tax result reached in the *Murphy* case would have obtained in an arm's length transaction. Surely, as in the instant case, the transferor would have insisted upon reimbursement for a pro-rata portion of the real property taxes paid had the transfer been to an independent third party. A precise analogy cannot be drawn, of course, since a distribution in liquidation—like a tax-free incorporation—presupposes that no independent party is involved. But, a disposition of real properties on which taxes had been paid would, as a matter of simple economics, involve bargaining for reimbursement, thus adding to the gain realized on the sale. More gain would entail more tax or, if expenses exceeded gain, a reduction in the loss. The then-existing absence of provisions for allocating real property taxes between vendor and vendee thus affords no basis for distinguishing the *Murphy* case.

What appellants have shown to this point is that both the Commissioner and the District Court used

the arm's length rationale in a mistaken manner. But the weight given the arm's length rationale by the District Court was a pivotal error. It was error because the *very basis of any tax-free transfer or reorganization is that it not be considered an arm's length sale or exchange.* The transferee has no alternative save to accept the tax basis of the transferor, regardless of what valuation figures might otherwise be used. Indeed, where taxpayers have tried to achieve taxable transfers to controlled corporations by the same mechanics as in this case, the Commissioner has treated the transaction as a tax-free exchange.

If the basic premise of an arm's length test has any validity, it should apply to the depreciables transferred, as well as the crop expenses, for they would not have been sold to a stranger for less than book value. But such complete application is, rightly, not urged in this case. It is clear, then, that the arm's length test cannot be used to alter the consequences of what is otherwise a tax-free transfer.

That there has been a flagrant misuse of Section 45 has already been shown by the fact that the allocation results in placing appellants in the worst possible tax position (p. 12). As was also shown, a similar effort by the Commissioner was struck down in the *Murphy* case (p. 13).

Additional authority that the action of the Commissioner constituted an abuse of his discretion is *Thomas W. Briggs* (1956) 15 TCM 441, 451. Petitioner had transferred accounts receivable to a controlled corporation and the Commissioner attempted to allocate the

income to the transferor under the authority of Section 45. The Tax Court held that the bona fides of the transaction were demonstrated by the absence of motive to evade taxes and the payment by the corporation of taxes on the income from the receivables, and it rejected the proposed allocation.

Another case involving facts parallel to those of the present case is *Mabee et al. v. Dunlap, et al.,* 51-2 USTC, paragraph 9366. There, the taxpayer transferred partially completed drilling contracts having a value in excess of $200,000.00 to a controlled corporation. The Commissioner was not allowed either to allocate to the corporation the drilling expenses incurred prior to transfer or to charge to the individual income realized by the corporation.

These are the only cases of which appellants have knowledge dealing with the question of an attempted disallowance of expenses or reallocation of income in the context of a 112(b)(5) incorporation, and the holding of both are that such action is not a permissible exercise of discretion.

The relative novelty of the Commissioner's contention is further exemplified by the small number of reported cases where Section 45 has been applied to transfers of agricultural commodities.

A leading case where Section 45 was not invoked is *Diamond A Cattle Co. v. Commissioner* (10th Cir. 1956) 233 F. 2d 739, in which a corporation distributed livestock to its sole shareholder on August 15th. Since almost all sales of livestock were (as was customary) made between September 1 and December

31, the corporation sustained a net operating loss resulting from expenses incurred prior to the distribution date. The Tenth Circuit Court of Appeals held that it could carry back such loss despite the sole shareholder's admission that he caused the liquidation to achieve a net operating loss. The entities and facts of the *Diamond A* case are identical to those of the instant case except that here the transfer was from an individual to a corporation.

The opinion of the District Court is misleading in its attempted distinction of *Diamond A* because a quote is used out of context. The District Court rightly observes that Section 45 was not in issue therein; it proceeds to state that:

> "As the taxpayer accrued the costs of raising the cattle, 'and in so accounting accrued and reported large amounts of income not received, representing to some extent at least, the increase and growth of the animals in its herds prior to the sale of those particular animals,' his situation was entirely different from that of the plaintiff's in the instant case."

The opinion thus appears to equate accrual of costs with inventorying of the taxpayer's livestock; in truth, there is no connection between the two. Moreover, inventorying—which appellants here were not permitted to do (post, pp. 21-25)—resulted in only a partial absorption of expense, and a net operating loss was generated by the transfer.

What the *Diamond A* case holds is simply that expenses must be reported in conformity with the history

of a transaction and the taxpayer's regularly employed and accepted method of accounting and not be subject to whimsical disallowance by the Commissioner.

The net result of the action of the Commissioner thus appears to be solely the frustration of tax consequences which Congress intended appellants should enjoy. As the court in the *Murphy* case, supra, held (231 F. 2d 639, at 645):

> "It is true that the dissolution of Murphy Company had tax consequences unfavorable to the Government. But as shown by the cases hereinabove referred to that does not authorize action under Section 45. Nor was dissolution illegal, improper or fraudulent. It was permissible corporate action which could have been taken by any corporation."

The principle applies with equal force to the required tax free incorporation of appellants and the resultant loss sustained by them.

Both the District Court and the Commissioner rely almost entirely upon the holding in *Central Cuba Sugar Co. v. Commissioner of Int. Rev.* (2nd Cir. 1952) 198 F. 2d 214. But neither take cognizance of the peculiar facts of that case. In the *Central Cuba Sugar* case taxpayer, a corporation, was engaged in raising and selling sugar. Pursuant to a plan of reorganization, taxpayer transferred all of its assets to a successor concern in November, having incurred substantial expenses in planting the crop later sold by its successor. The Commissioner's application

of Section 45 was upheld by the Court of Appeals (which reversed the Tax Court's holding for the taxpayer) on the ground that the division of the fiscal year in November resulted in distorting the income picture of a generally profitable operation. But in that case the transferee was a foreign corporation, the income of which could *never* be reached by the taxing authorities of this country. This is not true with regard to the income of the corporation owned by the appellants herein. (For a further discussion of the factual disparity between the instant case and *Central Cuba Sugar,* see post, p. 25.)

The court in *Central Cuba Sugar* relied upon the decision of the Fifth Circuit in *Jud Plumbing & Heating v. Commissioner of Int. Rev.* (1946) 153 F. 2d 681, and *Standard Paving C. v. Commissioner of Internal Rev.* (1951) 190 F. 2d 330, which was decided by the Tenth Circuit. Each of these cases involved a transferor corporation engaged in the construction business which customarily reported income on the "completed contract" method. In each case, although the contracts had been transferred prior to the date of completion, the courts held the income could be pro-rated to the date of transfer and attributed to the transferor corporation.

These cases merely hold that accounts receivable of a transferor may be treated as income upon liquidation of a corporation. Such treatment merely places the transferor on another recognized accounting method, i.e. the recognized percentage of completion method and results in the receivables being taxed

at ordinary income rather than capital gains rates. These cases are not relevant to the deductibility of expenses already incurred. Moreover, their rationale would require these appellants to adopt a prohibited method of accounting (see post, pp. 21-25).

Except for *Central Cuba Sugar,* the Commissioner has not generally relied upon Section 45 in transfers of agricultural commodities, but instead rested his attack on other provisions of the Code. In issue have been conversions of ordinary income items to capital assets through distributions of stock in trade to shareholders. The Commissioner found sufficient justification neither to attack these transfers under Section 45, nor to challenge the deductibility of expenses incurred by the transferor in producing the assets.

For example, in *Gensinger v. Commissioner* (7th Cir. 1953) 208 F. 2d 576, taxpayer liquidated his wholly owned corporation and distributed its assets, consisting of harvested fruit crops, to himself. Taxpayer's disposition of the harvested crops was treated as a capital gain, while a sale of the same crops by the corporation prior to distribution would have resulted in ordinary income. The critical issue was whether an effective transfer of the assets had been made to the taxpayer prior to the sale and the court found that there had been.

Similarly, in *Louisiana Irrigation and Mill Company* (1955), 14 TCM 1252, the Commissioner unsuccessfully attempted to treat a dividend in kind of rice, which was sold by the recipient shareholders,

as the income of the corporation, relying on Section 22(a) of the 1939 Code, now Section 61 of the Internal Revenue Code of 1954.

In *U. S. v. Horschel* (9th Cir. 1953) 205 F. 2d 646, a distribution of an apple crop in liquidation was attacked as being an anticipatory assignment of income. This argument was rejected by the court on the ground that the assets themselves had been distributed and, accordingly, income from the sale thereof could not be taxed to the liquidating corporation.

The Commissioner has made but one effort to use Section 45 in the context of a transfer of agricultural commodities by a corporation to its shareholders. This effort failed. In *Burrell Groves, Inc.,* (1951) 16 T.C. 1163, a corporation sold its assets, including unharvested crops, to its shareholders. Petitioner and its shareholders had not placed any value on the crops. The Commissioner allocated to the corporation an amount of ordinary income which he asserted was equal to the value of the crops. The Commissioner argued that the parties would have set a value in an arm's length transaction and that, accordingly, it was permissible to increase the amount of the corporation's income under Section 45. The Tax Court summarily rejected this contention, both on the grounds that the issue had been improperly raised and that there was no evidence in the record to support such an allocation.

Thus, it is clear that the singling out of the good faith transaction of these appellants is unwarranted

as a revenue measure, not in accordance with the theory of Section 45 and an aberration from the principles inherent in the pertinent authority. To sustain such novel and arbitrary attacks on a type of transfer that takes place in countless instances and conforms in every particular with applicable provisions of the Code will leave both taxpayers and their advisors without a shred of certainty as to the availability of unambiguous provisions of the law.

II

The District Court erroneously concluded that appellants were not entitled to deduct the expenses incurred by them individually in connection with the growing of the crop in question and to carry-back their net operating loss as permitted by Section 122 of the Internal Revenue Code of 1939. It is not in dispute that the expenses allocated by the Commissioner to the corporation were actually incurred by the appellants individually. Although these taxpayers were on an accrual basis, it is immatetrial whether they were on a cash or accrual basis as the money had actually been expended.

The only other accounting method which is available to farmers is the so-called "crop method", which requires that a farmer be engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing.

In the regulations under the 1954 Code that method is provided for in Subdivision (c) of Section 1.61-4. If a particular crop qualifies for this method of reporting, then the entire cost of producing the crop must be taken as a deduction for the year in which the gross income from the crop is realized, and not earlier. The record is clear that this method is not available in the case of hops which are planted in the spring and harvested in the fall.

Accordingly, appellants had no alternative but to deduct these expenses at the time and in the fashion which they did. *W. P. Sewell, et al.* (1944) 3 TCM 106, 118-119. In the *Sewell* case the taxpayer attempted to deduct in 1934, the year in which the crop was harvested, planting and cultivating expenses incurred in 1933. Because the crop did not qualify for the crop method, the expenses were required to be deducted in the year in which incurred. While Section 45 was not in issue in that case, the rationale of the decision is pertinent to the situation of these appellants. The Tax Court held that the only appropriate time at which expenses could be deducted was the accounting period in which they were incurred. In the *Sewell* case that accounting period was marked by the end of the calendar year.

If the purpose of Section 45 is to place these appellants on a parity with an uncontrolled taxpayer such as Sewell, then the only appropriate time at which appellants' expenses could have been deducted was the accounting period which included January 1 to July 31. A different entity operating in a successive ac-

counting and fiscal period should be prohibited from taking these deductions on the same theory that Sewell was.[2]

The practical result of this allocation was to require that appellants inventory the value of these unharvested crops, a result which both the courts and the Commissioner have consistently opposed.

The Commissioner has made his position on unharvested crops quite clear in a ruling under the 1921 Act (I.T. 1368, I-1 C.B. 72) which reads as follows:

> "While farmers may report their gross income upon the accrual basis (in which an inventory to determine profits is used), they are not permitted to inventory growing crops for the reason that the amount and value of such crops on hand at the beginning and end of the taxable year cannot be accurately determined. If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may be computed upon the crop basis; but in any such case the entire cost of producing the crops must be taken as a deduction in the year in which the gross income from the crop is realized. (See arts. 38 and 1586.) Nurserymen may inventory their young trees only where they have reached a marketable size and stage of development and where the market value is definitely known. If

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[2]It should be pointed out that there is absolutely no issue in this case with respect to the validity of the corporation's existence. It was organized for and engaged in business activities; consequently, it must be recognized as a separate entity. *National Carbide Corp. v. Commissioner* (1949) 336 U. S. 422, 428-429; *Moline Properties, Inc. v. Commissioner* (1943) 319 U. S. 436, 439; *O'Neill v. C.I.R.* (9th Cir. 1959) 271 F. (2d) 44, 49.

desired, the farm-price method of inventory described in article 1586 of Regulations 62 may be adopted."

The Commissioner has never deviated from this official position taken in I.T. 1368. Such official position is recognized in the following subsequent authorities and I.T. 1368 is cited in most of them: *Irrgang v. Fahs,* 94 F. Supp. 206 at 211 (D.C. Fla. 1950), holding that under I.T. 1368 citrus fruit not yet harvested from growing trees on plaintiff's land could not be included in inventory; *Amling-De Vor Nurseries, Inc. v. U.S.,* 139 F. Supp. 303 (D.C., N.D., Cal., 1956); *Perry v. U.S.,* 58-2 U.S.T.C. Par. 9587 (D.C., Miss., 1958); and *W. Cleve Stokes,* 22 T.C. 415 (1954), Acq. 1954-2 C.B. 5, holding that for the taxable years 1946 to 1949, I.T. 1368 was applicable to a nurseryman growing plants and shrubs.

The mechanics which demonstrate that the action of the Commissioner is tantamount to requiring appellants to inventory their unharvested crops are as follows: if it were permitted to inventory the unharvested crop, the fair market value thereof at the date of transfer would be added to the inventory account, and "cost of goods sold" would be reduced by that amount.

Thus, the expenses of appellants would be reduced by the fair market value of the unharvested crop. The Commissioner has achieved exactly the same result by denying appellants the deduction for expenses actually incurred by them.

In this connection, it is highly significant that the action of the Commissioner in the *Central Cuba Sugar* case did not have the result of requiring the transferor there to use a prohibited method of accounting. The deferral of an expense item by its allocation to the transferee corporation was perfectly permissible insofar as appropriate accounting methods are concerned, as the crop there was sugar cane, which requires more than one year from the time of planting to the date of gathering of and disposing. Accordingly, the crop method described above could have been used by the transferor corporation.

That appellants have, in effect, been forced to inventory the unharvested crop is but further evidence that the allocation in question was arbitrary and improper, as it results in the contravention of the accounting regulations promulgated by the Commissioner himself.

III

In its Finding of Fact No. 13 (R. 29) and by implication from its opinion (R. 22) the District Court erroneously concluded that there was present under the facts of this case the element of common control required by Section 45.

It is required that the control exist during the entire period in which the allocated item accrues. It was not until the transfer of assets to the corporation, effected as of July 31, 1954, that the corporation became a viable entity. Prior to that date, the appel-

lants had nothing which they could control as there existed only the vacuous corporate shell.[3]

The record is uncontroverted that the expenses here allocated were all incurred prior to the transfer of assets (R. p. 58, 73-74). Therefore, during the period in which the allocated item accrued, there was no dual operation over which appellants could exercise the arbitrary type of deflective control which Section 45 is designed to prevent.

Appellants have been unable to find any case involving Section 45, or its successor section, in which this element of common control did not exist during the entire period.

For a recognition of this principle, see *The Friedlander Corporation* (1955) 25 T.C. 70, in which the Tax Court carefully spelled out the nature of the common ownership during the entire period.

Further, the regulations under Section 45 of the 1959 Code, reg. 118, Secs. 39.45-1(b):

> "The purpose of Section 45 is to place a controlled tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled

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[3]Even if it be assumed that the corporation assumed an independent existence for purposes of Section 45 on May 27, 1954, the date on which its Articles were accepted for filing by the Secretary of State of the State of California, the record still indicates that the expenses of planting and cultivating the crop were incurred in the "early part of the year" (R. p. 58). Due to the rather unusual admission, by stipulation, of a proposed format of testimony to be given by Mr. Rooney, the period in which such expenses are incurred is not pinpointed to a date prior to May 27th.

> taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. * * * The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

In determining whether or not appellants here dealt with their successor corporation "at arm's length" in allocating the accrued expenses, it is obvious that two taxable entities must have existed at the time of such accrual or there could have been no dealings at all. As has been demonstrated, there was no corporation in existence at such time with which the appellants could deal.

IV

In its Findings of Fact Nos. 2 and 3 (R. 25-26), and its Conclusion of Law No. 5 (R. 30), the District Court suggests that appellants have not sustained their burden of proof. There is no mention of this in the court's opinion.

However, Finding of Fact No. 2 (R. 25) sets forth that appellants have paid the deficiencies of $22,553.02 together with statutory interest thereon to date of payment as a result of the deficiencies proposed by the District Director of Internal Revenue resulting from the allocations in issue here. Thus, the court

has found the exact sum which the Commissioner placed in issue and the fact of appellants' payment of that sum, which establishes with exactitude the amount appellants are entitled to recover.

CONCLUSION

Contrary to the objectives which Section 45 by its terms is designed to achieve, its application to the facts of the instant case results in a distortion of the true income and expense picture of the entities involved. Further, to permit such a novel and arbitrary employment of the Commissioner's alleged "discretion"—contrary to the principles of germane cases—would result in requiring appellants to report on a prohibited method of accounting. Such a precedent could generate serious injustice in manifold instances, while not in any way required to protect tax revenues.

Dated, San Francisco, California,
July 3, 1961.

Respectfully submitted,
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